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31 March 1987

Foreign Investment in China in 1986 and Prospects for 1987 [redacted] 25X1

Summary

Foreign investment in China rose 10 percent last year to more than $2 billion, but the level of new foreign investment pledged fell nearly 50 percent. The much-touted foreign investment regulations introduced in late 1986 were disappointing because they failed to adequately address investors' key concerns, and most US firms continue to cite the difficulties of operating in China. The current political debate over the pace and direction of economic reform has further increased investor uncertainty, and many have adopted a wait-and-see attitude. The fluidity of the current political and economic scene in China will also slow progress on conclusion of a Sino-US bilateral investment treaty. [redacted] 25X1

Foreign Investment in 1986

China absorbed more than $2 billion in foreign investment funds last year, according to the Ministry of Foreign Economic Relations and Trade (MOFERT), a 13-percent increase over 1985. This brings the level of total foreign investment

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This memorandum was prepared by [redacted] Office of East Asian Analysis. 25X1
Information available as of 27 March 1987 was used in its preparation. Comments and queries are welcome and may be directed to the Chief, China Division, OEA, [redacted] 25X1
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absorbed since 1979 to $7.4 billion, and the total number of equity and contractual joint ventures and wholly foreign-owned enterprises to 7,500 (see figure 1). 25X1

But the more meaningful indicator of foreign investment, the level of new investment pledged, fell nearly 50 percent last year to $3.3 billion. Chinese officials attribute much of this decline to Beijing's attempts to shift foreign investment away from the service sector and toward advanced technology and export-oriented production. Of the nearly 1,500 Sino-foreign contracts approved last year--870 equity joint ventures, more than 560 contractual joint ventures, 18 wholly foreign-owned enterprises, and 6 contracts for cooperation in off-shore oil--70 percent were categorized as "productive enterprises" by MOFERT. 25X1

Chinese officials also point to other factors associated with the drop in foreign investment contracts, such as a domestic credit crunch and declining foreign exchange reserves. As restrictive credit policies were introduced to slow the overheated economy, Chinese partners were hard pressed to obtain the domestic financing they required. Concern over balance-of-payments and repatriation problems led potential foreign investors to adopt a wait-and-see attitude. Adding to the downturn, prospective foreign investors postponed investments because Beijing promised more favorable investment regulations. But the new regulations designed to encourage foreign investment, announced amid much fanfare last October, fell short of the "bold measures" promised. Notably absent from the guidelines were two key issues--access to China's domestic market and access to foreign exchange to remit profits (see box). Furthermore, only two of the more than 10 promised regulations intended to ensure proper implementation of the overall investment guidelines have been issued. Both of these supplemental regulations--detailing the customs and labor provisions--were issued in late 1986, with the remainder scheduled to follow in the early weeks of 1987. 25X1

To further encourage foreign investment, the State Economic Commission urged localities to experiment with the new guidelines, and many provinces and municipalities responded with additional enticements. Ironically, excessive diversity could lead to less certainty and more confusion for foreign investors, who already complain about the lack of consistency in China's investment climate. In most cases, however, local incentives offer only minor variations of the central regulations, particularly where the regulations refer to local government discretion--for example, in further reductions in local taxes and site-use fees. In several instances, however, the critical issue of foreign exchange has been treated in more detail, offering local government funds to cover temporary foreign exchange imbalances. Some localities also are offering priority consideration for access to the domestic market for sales--at least partially in foreign exchange--of previously imported goods. 25X1

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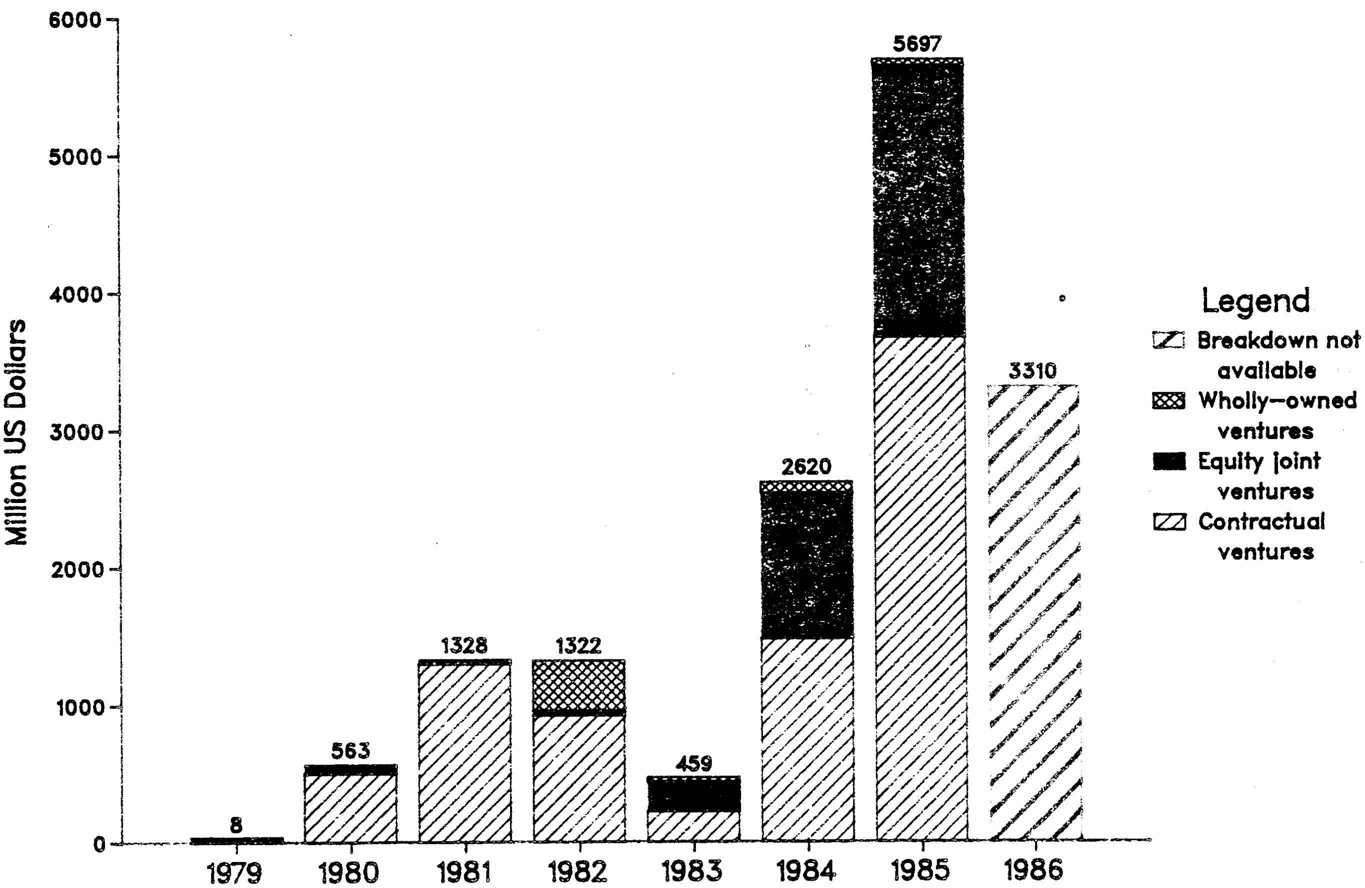
Figure 1.
China: Value of Foreign Investment Contracted by Year and Type



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China's New Foreign Investment Guidelines

Provisions affecting all foreign enterprises:

- o Guaranteed autonomy over production, funds, inputs, wage and bonus levels, and personnel--including the right to hire and fire workers and senior managers.
- o Import-license exemptions for machinery and equipment, vehicles, raw materials, and spare parts required for production.
- o Export of production directly or through agents, with export licenses, where applicable, obtained at six-month intervals rather than on a case-by-case basis.
- o Exemption from income taxes payable on profits if subsequently reinvested in expanding or establishing export-oriented or advanced technology enterprises.
- o Authority for foreign enterprises to adjust foreign exchange surpluses and deficits among themselves.
- o Maximum three-month waiting period for official responses to investment matters that require approval by state and/or local departments.

Additional preferential treatment accorded foreign export-oriented and advanced technology enterprises:

- o Exemption from the payment of state wage subsidies to Chinese employees, with the exception of labor insurance, welfare, and housing.
- o Reduction and standardization of site-use fees.
- o Priority status for the provision of water, electricity, transportation services, and communication facilities at rates on par with those paid by state enterprises.
- o Preferential access to short-term loans.
- o Reduced income taxes after the expiration of applicable tax holidays as well as income tax exemptions on profits remitted abroad. [redacted]

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US Investment in China

The United States remains one of China's largest investors--second only to Hong Kong, which represents roughly two-thirds of total foreign investment in China. There were some notable successes for US investors last year. After a wave of negative media attention to the severe foreign exchange problems at the Beijing Jeep Corporation early in the year, Chinese and US officials negotiated a settlement. Babcock and Wilcox Beijing Company, Inc., another high-visibility US joint venture, also successfully got off the ground last year. Despite some initial frictions over wage subsidies and surplus labor, the general manager of the Babcock and Wilcox venture recently expressed great satisfaction with the enterprise. [redacted] 25X1

Although these two apparent successes are encouraging, not all joint ventures operating in China enjoy the favorable treatment afforded these high-visibility firms. Recent conversations with the US business community in Shanghai produced a litany of complaints including:

- Contract and project approvals continue to take much longer than the maximum 30 days stipulated in the new regulations. Moreover, the process remains confusing and unclear.
- Tax laws are applied differently throughout China.
- The Foreign Enterprise Service Corporation has requested a 40-percent increase in the surcharge for Chinese employees.
- A 10-percent rate increase and 10-percent service charge have been imposed on long-term hotel rooms, despite existing contracts. The situation for offices is not as bad, although there have been some "tack ons" such as maintenance fees and service charges.
- Telecommunications charges have been increased 50 percent, unrelated to any change in service. [redacted] 25X1

Foreign Investment and Bourgeois Liberalism

Already disappointed by the lack of improvement in China's investment climate in the wake of Beijing's new investment guidelines, foreign investors are now facing increased uncertainty because of the ongoing debate over the pace and focus of economic and political reform. Despite Beijing's claims that there will be no change in China's opening to the outside world, use of foreign capital, or cooperation with foreigners, by late February the US Embassy reported that a heavy pall had settled on the foreign community in Beijing. [redacted] 25X1

According to the US Embassy in Beijing, some experienced US businessmen have suggested that the current political situation, with the emphasis against imitating Western ways, may eventually affect their ability to maintain normal business relations

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and activities in China. Specifically, there is concern that the close working relationships between foreign businesses and their Chinese Government and commercial counterparts--which in many cases have been fostered over several years--might be jeopardized. Some investors speculate that such an estrangement may have a disastrous effect on joint ventures that rely on close day-to-day contact between Western and Chinese partners. We also suspect that factory managers in joint ventures may have a tougher time shrugging off party interference in production and even in management decisions. Western businessmen speculate there may, for example, be a greater tendency to defer decisions to a higher level within the enterprise--or even to sponsoring ministries--especially if they relate to aspects of business that are expected to receive increased scrutiny: commitment of foreign funds, sending Chinese employees abroad for training, and even specific foreign purchase and sales decisions. 25X1

In his March meeting with Secretary Shultz, Vice Premier Li Peng reiterated earlier official statements that the economic policy reorientation was not related to political events. Nevertheless, to deal more effectively with government budget and foreign trade deficits, Beijing is reducing domestic investment in many construction projects and readjusting the composition of imports. Furthermore, Li's earlier warning to a visiting French diplomat that foreign businessmen should be prepared for possible contract cancellations and a closer review of future contracts sounded ominous to US firms.

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Prospects for 1987

Most ongoing commercial projects appear unaffected by either changes in the political atmosphere or underlying economic factors, according to the US Embassy in Beijing. But foreign businesses that had been contemplating major investments in China or increasing their presence there to handle anticipated sales and service contracts are now delaying major decisions. For many, the next signpost will be the outcome of the 13th Party Congress later this year--which should clarify Beijing's approach to economic development. In the meantime, many of the funds that foreign investors had earmarked for China will be spent elsewhere. 25X1

Beijing's new belt-tightening campaign will also affect technology transfer, because the cutback in foreign training of Chinese staff increases the difficulty of introducing many advanced technology packages included in contracts with foreign firms. According to the US Embassy in Beijing, Chinese enterprises authorized to purchase foreign equipment are now being denied permission to send Chinese employees abroad for training if the Chinese side is expected to bear the cost of foreign travel. Foreign companies in many cases will find it expensive or impossible to provide equivalent training in China. 25X1

The fluidity of the current political and economic scene does not bode well for progress in negotiating a Sino-US bilateral investment treaty. Politically, the recent attacks on Westernization and increasing antiforeign themes in the Chinese media will make it difficult for Beijing to concede on the primary outstanding issues of national treatment and dispute settlement. Economically, Beijing appears unwilling to remove the obstacles to foreign exchange transfers given MOFERT's recent announcement that foreign exchange allocation reforms will not go ahead this year as planned. 25X1

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